



**WESTERN WATER
COMPANY**

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Michael Patrick George
President and Chief Executive Officer

October 26, 1998

The Honorable Bruce Babbitt
Secretary
United States Department of the Interior
18th & C Streets, NW
Washington, DC 20240

Dear Secretary Babbitt,

Thank you for the opportunity to join you on October 9 in San Francisco and to share my views on water transfers in the context of the CALFED Bay-Delta Program. The discussion underscored the need for a coherent approach to making water transfers a workable mechanism for allocating a scarce resource. I have two major concerns about the current status of transfer discussions as part of CALFED. First, the proposed timeline is seriously flawed; we need interim transfer rules by the end of next year in order to evaluate the impact of water transfers during Stage One. Second, open access to public conveyance facilities is being thwarted by narrow implementation rules that actually restrict such access; we need to assure fair access to public conveyance systems in order to promote the development of water markets.

Interim Transfer Rules Are Critical

The flaw in CALFED's current drafts is the timetable for developing the water transfer program, a necessary element for a viable water market. During Stage One, we will need to create a track record of years of competitive, market-based water transfers to be able to evaluate the impact of the water market and to determine how to proceed in Stage Two. How can CALFED hope to develop a consensus to proceed (or dispense) with the isolated facility or off-stream storage in Stage Two if it has gathered no data on the impact of voluntary water marketing? However, under the current draft timetable, rules that must be in place for such a market to develop will not be finalized until the end of Stage One.

To properly evaluate a market, that market should include (as voluntary transactions) water moving through the Delta from north-to-south, from basin-to-basin, and under a variety of climatic conditions.

The rules and procedures that must be in place, and clear to everyone, are not currently proposed to be in place until the very time that the information derived from water transfer experience may be needed. A market will not just spring into being, fully formed, the moment rules are in place. It will take at least a couple of years for a market to develop, and some years beyond that to demonstrate a successful track record. We strongly suggest that interim rules be in place at the start of Stage One (by December 31, 1999), so that all parties can fairly evaluate the impact of water transfers before having to choose implementation strategies for Stage Two. (Please see the attached brief discussion paper on the interim rules which Western Water Company believes should be adopted in order to foster an efficient and fair market.)

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Greater Access to Public Facilities Is Needed

Since passage of the Central Valley Project Improvement Act (1992), it has been federal policy to promote voluntary water marketing. That policy is also established in California law under the Wheeling Statute (California Water Code Section 1810). However, poor implementation of these policy directives actually results in restricted access and makes conveyance of transfer water impossibly expensive and logistically impractical. The agencies charged with implementing this public policy have shown no interest in a competitive, price-sensitive water market.

Most of the long-distance water conveyance facilities in California and the West are owned by public agencies and were developed with public credit and users' fees. Nonetheless, current and proposed operating contracts restrict access to available capacity in these facilities in a way that inhibits voluntary water marketing. Access to the State Water Project is a prime example: Under the Monterey Agreement, contractors are given both preferential rights to use of the excess capacity in the facility and a back-door way of restricting their customers' access to competitive water resources. Contractors move non-Project water through the system by paying only the Project's "included cost of power." Non-contractors, however, must negotiate a rate that is much less favorable. In a recent transaction of ours, the difference was estimated at \$50/AF (through a contractor) versus \$288/AF (to contract directly with DWR).

This huge access price differential is defended on the grounds that the contractors have paid the fixed cost of the facilities for their Project supplies, so they should be able to use excess capacity to economically move non-Project supplies that they acquire. Non-contractors (including transfer proponents), so the argument goes, should not get a "free ride" on the contractors' fixed price obligations. This argument has three critical flaws: First, it ignores the public benefit of variable cost access to excess capacity and perpetuates a non-competitive, essentially political allocation system. Second, it ignores the fact that the contractors' fixed payments guarantee availability of capacity while occasional users only gain access to excess capacity. Third, it ignores the public policy imperative of maximizing the use of existing facilities before building more and redundant capacity.

The contractors' advantage goes beyond price. The Monterey Agreement also acts as a back-door market allocation mechanism. That is because the favorable price is available to contractors only to bring non-Project water *to their own service territory*. As a practical matter, this limitation allows each contractor to protect its service territory from outside water.

As an alternative, more in keeping with the public policy favoring voluntary water transfers and supporting efficient use of public facilities, I suggest that the U.S. Bureau of Reclamation and CALFED push for truly open access. As the condition of public support, the public agencies who control exclusive access facilities should be obligated to make excess capacity available--as the law intends--to facilitate transfers. Current operating policies clearly thwart that objective.

Thank you for taking our insights and experience into account in fashioning a Bay/Delta solution that enhances the opportunity for voluntary water transfers to play a meaningful part in balancing supply, demand and environmental needs.

Sincerely,



attachment

cc: The Honorable Pete Wilson
Resources Secretary Doug Wheeler
Lester A. Snow
Roger K. Patterson
David N. Kennedy

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